

Pool Party continues but waiting on the Gas

Maintain Rating: BUY | PO: 45.00 USD | Price: 42.06 USD



Equity | 08 August 2019

Executing on Legacy Water Biz and Tuck-Ins

WTR's latest update shows further execution on the core water business and continued focus on tuck in acquisitions. Following Ohio's adoption of FMV legislation in January, the company announced a purchase agreement earlier this month to acquire a small utility in Campbell (3.2K customers) to drive the latest addition to the \$100Mn in expected rate base from signed muni acquisitions. Outside of the Peoples acquisition, we expect water tucks ins to continue driving incremental growth. The Fair Market Value legislation has been passed in 7 of the 8 states the company operates in (following TX in June). Thus, we could see mgmt start to pursue a wider geographic footprint as additional states become more appealing; mgmt highlighted a path to 30K customers as critical. More materially, we highlight DELCORA's recent announcement of intent to commit to exclusive discussions with WTR for a potential acquisition. While purchase price (& thus rate base opportunity) are yet to be negotiated, FMV legislation potentially could facilitate a step up from the ~\$240Mn depreciated asset base. If such a scenario materializes, it could be a meaningful driver, albeit it may come with some kind of equity issuance.

Peoples Acquisition Remains on Track: October Order?

Following earlier approvals from the KY and WV PSCs for the Peoples acquisition, the company continues to await final approval from PA after filing a non-unanimous settlement. Latest commentary from management highlighted expectations for an October order from the commission with the transaction to close shortly after. Following the close of the transaction, we would expect more guidance around any upside at the Analyst Day tentatively set for December 5th.

Valuation: Repairs Tax Upside Remains Key

With the latest developments, our estimates are unchanged. We remain above the street as we still credit the company with execution of the repairs tax benefit. Our PO ultimately remains unchanged at \$45. Maintain Buy given what we perceive as meaningful upside to estimates from Repairs Tax Benefit and further potential re-rating of shares as comfort emerges on the combined outlook.

Estimates (Dec)

(US\$)	2017A	2018A	2019E	2020E	2021E
EPS	1.36	1.41	1.30	1.74	1.75
GAAP EPS	1.36	1.41	1.30	1.74	1.75
EPS Change (YoY)	3.0%	3.7%	-7.8%	33.8%	0.6%
Consensus EPS (Bloomberg)			1.36	1.57	1.66
DPS	0.81	0.86	0.92	0.99	1.06

Valuation (Dec)

	2017A	2018A	2019E	2020E	2021E
P/E	30.9x	29.8x	32.4x	24.2x	24.0x
GAAP P/E	30.9x	29.8x	32.4x	24.2x	24.0x
Dividend Yield	1.9%	2.0%	2.2%	2.3%	2.5%
EV / EBITDA*	1.1x	8.1x	26.5x	16.6x	15.8x
Free Cash Flow Yield*	-1.1%	-1.4%	-1.9%	-1.3%	-1.0%

* For full definitions of *IQmethod*SM measures, see page 8.

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Stock Data

Price	42.06 USD
Price Objective	45.00 USD
Date Established	15-Jul-2019
Investment Opinion	A-17
52-Week Range	32.09 USD - 42.32 USD
Mkt Val (mn) / Shares Out	9,074 USD / 215.7 (mn)
Average Daily Value (mn)	43.86 USD
BofAML Ticker / Exchange	WTR / NAS
Bloomberg / Reuters	WTR US / WTR.N
ROE (2019E)	7.5%
Net Dbt to Eqty (Dec-2018A)	127.1%

DELCORA: Delaware County Regional Water Control Authority

PSC: Public Service Commission

FMV: Fair Market Value

iQmethodSM – Bus Performance*

(US\$ Millions)	2017A	2018A	2019E	2020E	2021E
Return on Capital Employed	5.1%	3.9%	4.4%	5.2%	5.1%
Return on Equity	12.6%	9.7%	7.5%	8.6%	8.3%
Operating Margin	41.5%	38.7%	48.1%	70.2%	71.1%
Free Cash Flow	(97)	(127)	(170)	(120)	(87)

iQmethodSM – Quality of Earnings*

(US\$ Millions)	2017A	2018A	2019E	2020E	2021E
Cash Realization Ratio	1.6x	1.9x	1.9x	1.8x	1.9x
Asset Replacement Ratio	3.5x	3.4x	3.3x	2.6x	2.5x
Tax Rate	6.6%	NM	10.0%	10.0%	10.0%
Net Debt-to-Equity Ratio	108.3%	127.1%	97.0%	100.1%	102.8%
Interest Cover	3.9x	2.8x	3.4x	3.5x	3.3x

Income Statement Data (Dec)

(US\$ Millions)	2017A	2018A	2019E	2020E	2021E
Sales	805	835	902	949	966
% Change	0.6%	3.7%	8.0%	5.3%	1.7%
Gross Profit	810	838	1,044	1,596	1,657
% Change	-1.3%	3.5%	24.6%	52.9%	3.8%
EBITDA	14,226	1,941	597	953	998
% Change	-33.6%	-86.4%	-69.2%	59.6%	4.8%
Net Interest & Other Income	(88)	(99)	(132)	(194)	(210)
Net Income (Adjusted)	240	192	251	414	416
% Change	2.4%	-19.9%	31.0%	64.5%	0.6%

Free Cash Flow Data (Dec)

(US\$ Millions)	2017A	2018A	2019E	2020E	2021E
Net Income from Cont Operations (GAAP)	240	192	287	442	446
Depreciation & Amortization	137	147	191	330	356
Change in Working Capital	NA	NA	NA	NA	NA
Deferred Taxation Charge	14	(15)	0	0	0
Other Adjustments, Net	(9)	45	(10)	(26)	(3)
Capital Expenditure	(478)	(496)	(639)	(865)	(885)
Free Cash Flow	-97	-127	-170	-120	-87
% Change	NM	-31.5%	-33.9%	29.8%	27.7%

Balance Sheet Data (Dec)

(US\$ Millions)	2017A	2018A	2019E	2020E	2021E
Cash & Equivalents	4	4	3	5	5
Trade Receivables	99	101	126	193	200
Other Current Assets	28	42	46	57	58
Property, Plant & Equipment	5,400	5,930	9,103	9,638	10,168
Other Non-Current Assets	801	887	2,462	2,462	2,462
Total Assets	6,332	6,964	11,741	12,355	12,893
Short-Term Debt	117	160	288	310	331
Other Current Liabilities	167	239	258	309	315
Long-Term Debt	2,008	2,398	4,305	4,638	4,955
Other Non-Current Liabilities	2,083	2,158	2,158	2,158	2,158
Total Liabilities	4,375	4,955	7,008	7,415	7,758
Total Equity	1,958	2,009	4,733	4,940	5,135
Total Equity & Liabilities	6,332	6,964	11,741	12,355	12,893

* For full definitions of iQmethodSM measures, see page 8.

Company Sector

Water Utilities

Company Description

Aqua America is a regulated water utility providing water or wastewater services to 3M customers in the states of PA, OH, TX, IL, NC, NJ, IN, and WV, with PA segment being the largest contributor to the NI. In Oct 2018, The company announced acquisition of Peoples Gas, a gas utility providing distribution services to 740,000 customers in PA, WV, and KY. The acquisition is expected to be closed by mid- 2019.

Investment Rationale

We see our Buy rating as supported by meaningfully above Street EPS projections on the back of its pending Peoples Gas business and above average ratebase growth.

Stock Data

Average Daily Volume 1,042,678

Quarterly Earnings Estimates

	2018	2019
Q1	NA	NA
Q2	NA	NA
Q3	NA	NA
Q4	NA	NA

Capitalizing on Fair Market Value Legislation

During 2Q, Texas became WTR's seventh state to adopt Fair Market Value Legislation when they adopted the legislation in June after Ohio adopted the legislation earlier in the year. Just this month, the company entered a purchase agreement to acquire the water system in Campbell, OH (3,200 customer connections), bringing the total signed purchase agreements for municipalities to 22.6K customers in 2019 and 2020. With WTR the only regulated water utility on size after acquiring operations from AWK, we could see more development in this state in particular following the latest move. Overall, management has noted ~\$100Mn in rate base acquisition activity signed set to generate ~\$5Mn of incremental earnings. While some of the transactions will close in 2020, the company remains on track to grow customers between 2-3% in 2019.

More materially than the typical tuck-ins, the board of directors of Delaware County Regional Water Control Authority (DELCORA) announced a letter of intent in July committing to exclusive discussions with Aqua Pennsylvania Wastewater that could result in a combination with DELCORA, who currently serves 500K people in 42 municipalities across Delaware and PA. While a sizable opportunity, management noted it would look to put an ATM program in place to raise some add'l equity, partially offsetting potential upside. Aside from a major acquisition, the company doesn't expect any other additional near term equity needs.

On the call, management noted a willingness to expand its footprint to additional states as Fair Market Value legislation gains momentum. We believe All expansion to additional states is increasingly likely following the successful push for passage of the legislation in 7 of the 8 states they operate in.

Peoples Acquisition: Still Guiding to Fall Close

The company received regulatory approval for the Peoples transaction from the Kentucky Public Service Commission in March and the West Virginia Public Service Commission in April after reaching unanimous settlements in the states. Following the approvals in those jurisdictions, the company filed a PA settlement agreement in June that is currently pending before the PA PUC (all but 2 intervenors to the case have entered into or chosen not to oppose the settlement agreement). With the settlement currently under review by the commission given the non-unanimous nature, the company continues to guide to a Fall decision. Specifically, management noted on the call that they expect an order from the commission on October 24th, with the transaction closing shortly after. That said, there is no statutory timeline for the commission to rule on the decision in the state.

EPS Estimates

The exhibit below reflects our EPS estimates which are largely unchanged as we await further developments on the pending acquisition. We remain above the street on '21, driven primarily from an expectation of stronger earnings at Peoples Gas. Earned ROE degradation at PA (assumed to be a gradual process) drives the relatively flat outlook for the core water utilities through the near term. *We appreciate there is substantial latitude in framing the '20 EPS & beyond based on the outlook of this acquisition around repairs tax. We emphasize the shape & form of deal approval remain critical to earnings trajectory, particularly given some mgmt commentary on smoothing its outlook. We stress some scenarios could result in EPS higher than Street consensus still though.*

Table 1: WTR SOTP

EPS Estimates	2019E	2020E	2021E	2022E	2023E
PA	\$0.84	\$0.80	\$0.77	\$0.82	\$0.86
OH	\$0.07	\$0.07	\$0.07	\$0.08	\$0.08
IL	\$0.08	\$0.07	\$0.08	\$0.08	\$0.09
TX	\$0.07	\$0.06	\$0.06	\$0.06	\$0.06
NC	\$0.04	\$0.04	\$0.04	\$0.04	\$0.05
Other States	\$0.08	\$0.08	\$0.09	\$0.09	\$0.10
Water Utility	1.18	1.12	1.11	1.17	1.24
Peoples Gas	0.17	0.70	0.75	0.79	0.82
<i>Parent & Other</i>	<i>-0.05</i>	<i>-0.08</i>	<i>-0.10</i>	<i>-0.12</i>	<i>-0.14</i>
EPS	1.30	1.74	1.75	1.84	1.92
YoY Growth		34%	1%	5%	4%
Shares O/S	193	238	238	250	254
Fully Diluted Shares O/S	221	254	254	254	254
<i>Previous EPS</i>	<i>\$1.22</i>	<i>\$1.74</i>	<i>\$1.75</i>	<i>\$1.84</i>	
Consensus	1.36	1.57	1.66		

Source: BofA Merrill Lynch Global Research, Bloomberg

Valuation

On our unchanged estimates, our PO remains \$45. We continue to apply a 1x discount to Peoples Gas to reflect related removal of any sector takeout premium as well as discounting the strong returns we ascribe to it in the near term.

Table 2: WTR SOTP

Table 2: WTR 501

Water Utilities	2021 EPS		P/E Multiple				Equity Value		
		Peer	Prem/Disc	Low	Base	High	Low	Base	High
Peer Water P/E		26.2x							
Group EPS '18-'22 CAGR		8.30%							
1-year forward group Water multiple		28.4x							
Water Utilities									
States	2021E EPS ROE embedded								
PA	\$0.77	10.0%	0.0x	27.4x	28.4x	29.4x	\$21	\$22	\$23
OH	\$0.07	9.9%	0.0x	27.4x	28.4x	29.4x	\$2	\$2	\$2
IL	\$0.08	9.6%	0.0x	27.4x	28.4x	29.4x	\$2	\$2	\$2
TX	\$0.06	10.0%	0.0x	27.4x	28.4x	29.4x	\$2	\$2	\$2
NC	\$0.04	9.9%	0.0x	27.4x	28.4x	29.4x	\$1	\$1	\$1
Other (including acquisitions)	\$0.09	9.9%	0.0x	27.4x	28.4x	29.4x	\$2	\$2	\$3
Water utilities total (ex-Peoples)	\$1.11			27.4x	28.4x	29.4x	\$30	\$31	\$33
Gas Utilities									
Peer Gas P/E		21.2x							
Group EPS '18-'22 CAGR		5.80%							
Peoples Gas Multiple		22.4x							
	2021E EPS ROE embedded								
Peoples Gas	\$0.75	14.1%	-1.0x	20.4x	21.4x	22.4x	\$15	\$16	\$17
HoldCo Debt									
(50% Netting out Debt) @ Aqua Parent			-727	50%			(\$363)	(\$363)	(\$363)
(50% P/E multiple on Interest Exp)			4.3%	50%			(\$351)	(\$325)	(\$379)
50/50 Weighted Drag from HoldCo Drag							(\$715)	(\$688)	(\$743)
Fully Diluted Shares Outstanding							254	254	254
PO							\$43.00	\$45.00	\$46.00
Current Price								\$42.06	
Dividend Yield								2%	
Total Return								9.18%	

Source: BofA Merrill Lynch Global Research, Bloomberg

Price objective basis & risk

Aqua America (WTR)

Our price objective is \$45 based on our SOTP approach, applying a peer multiple to the water utility and gas utility, respectively and accounting for expected growth for each sector. We apply a 1.0x discount to Peoples Gas as we expect earned ROEs to be driven down over time. We net out parent debt and parent interest expense associated with parent debt 50/50 weighed basis.

Specifically, we derive a value of \$31 for the Water Business and \$16 per share for the Gas utilities. We then deduct \$688M which accounts for \$2 per share, and gives us our PO of \$45.

Risks to the downside are acquisition risk, deteriorating regulatory outcomes, and risks from a lower rating following the diversification into gas.

Analyst Certification

I, Julien Dumoulin-Smith, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

US - Electric Utilities, Alternative Energy & LNG Coverage Cluster

Investment rating	Company	BofA Merrill Lynch ticker	Bloomberg symbol	Analyst
BUY				
	Alliant Energy Corporation	LNT	LNT US	Julien Dumoulin-Smith
	American Electric Power	AEP	AEP US	Julien Dumoulin-Smith
	Aqua America	WTR	WTR US	Julien Dumoulin-Smith
	Atlantica Yield	AY	AY US	Julien Dumoulin-Smith
	CenterPoint Energy	CNP	CNP US	Julien Dumoulin-Smith
	Cheniere Energy Inc	LNG	LNG US	Julien Dumoulin-Smith
	Clearway Energy	CWENA	CWEN/A US	Julien Dumoulin-Smith
	Clearway Energy	CWEN	CWEN US	Julien Dumoulin-Smith
	CMS Energy	CMS	CMS US	Julien Dumoulin-Smith
	Consolidated Edison	ED	ED US	Julien Dumoulin-Smith
	Emera Inc	YEMA	EMA CN	Julien Dumoulin-Smith
	Entergy	ETR	ETR US	Julien Dumoulin-Smith
	Evergy, Inc	EVRG	EVRG US	Julien Dumoulin-Smith
	Exelon	EXC	EXC US	Julien Dumoulin-Smith
	FirstSolar, Inc.	FSLR	FSLR US	Julien Dumoulin-Smith
	FirstEnergy	FE	FE US	Julien Dumoulin-Smith
	Fortis	YFTS	FTS CN	Julien Dumoulin-Smith
	Fortis Inc	FTS	FTS US	Julien Dumoulin-Smith
	NextEra Energy	NEE	NEE US	Julien Dumoulin-Smith
	NRG Energy	NRG	NRG US	Julien Dumoulin-Smith
	Pinnacle West	PNW	PNW US	Julien Dumoulin-Smith
	SunRun	RUN	RUN US	Julien Dumoulin-Smith
	Vivint Solar	VSLR	VSLR US	Julien Dumoulin-Smith
NEUTRAL				
	AES	AES	AES US	Julien Dumoulin-Smith
	Algonquin Power & Utilities Corp	AQN	AQN US	Julien Dumoulin-Smith
	Algonquin Power & Utilities Corp	YAQN	AQN CN	Julien Dumoulin-Smith
	Ameren Corporation	AEE	AEE US	Julien Dumoulin-Smith
	Black Hills Corporation	BKH	BKH US	Julien Dumoulin-Smith
	Bloom Energy	BE	BE US	Julien Dumoulin-Smith
	Dominion Energy	D	D US	Julien Dumoulin-Smith
	Edison International	EIX	EIX US	Julien Dumoulin-Smith
	Hannon Armstrong	HASI	HASI US	Julien Dumoulin-Smith
	NextDecade	NEXT	NEXT US	Julien Dumoulin-Smith
	NextEra Energy Partners	NEP	NEP US	Julien Dumoulin-Smith
	OGE Energy Corp	OGE	OGE US	Julien Dumoulin-Smith
	Pattern Energy Group	PEGI	PEGI US	Julien Dumoulin-Smith
	PNM Resources Inc.	PNM	PNM US	Julien Dumoulin-Smith
	Portland General Electric Company	POR	POR US	Julien Dumoulin-Smith
	PPL Corporation	PPL	PPL US	Julien Dumoulin-Smith
	Public Service Enterprise Group	PEG	PEG US	Julien Dumoulin-Smith
	Sempra Energy	SRE	SRE US	Julien Dumoulin-Smith
	Southern Company	SO	SO US	Julien Dumoulin-Smith
	Vistra Energy	VST	VST US	Julien Dumoulin-Smith
	Xcel Energy Inc	XEL	XEL US	Julien Dumoulin-Smith
UNDERPERFORM				
	American Water Works	AWK	AWK US	Julien Dumoulin-Smith
	Avangrid	AGR	AGR US	Julien Dumoulin-Smith
	Avista	AVA	AVA US	Richard Ciciarelli, CFA
	DTE Energy	DTE	DTE US	Julien Dumoulin-Smith
	Duke Energy	DUK	DUK US	Julien Dumoulin-Smith
	Eversource Energy	ES	ES US	Julien Dumoulin-Smith
	Hawaiian Electric Industries	HE	HE US	Julien Dumoulin-Smith
	Idacorp	IDA	IDA US	Julien Dumoulin-Smith
	NorthWestern Corporation	NWE	NWE US	Julien Dumoulin-Smith
	SunPower Corp.	SPWR	SPWR US	Julien Dumoulin-Smith
	Terraform Power	TERP	TERP US	Julien Dumoulin-Smith
	Unitil Corporation	UTL	UTL US	Julien Dumoulin-Smith
	WEC Energy Group Inc	WEC	WEC US	Julien Dumoulin-Smith
RSTR				
	El Paso Electric Company	EE	EE US	Julien Dumoulin-Smith

iQ^{method}™ Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	$\text{Total Assets} - \text{Current Liabilities} + \text{ST Debt} + \text{Accumulated Goodwill Amortization}$
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	$\text{Net Debt} = \text{Total Debt, Less Cash \& Equivalents}$	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	$\text{Market Cap.} = \text{Current Share Price} * \text{Current Basic Shares}$
Enterprise Value / Sales	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Other LT Liabilities}$	Sales
EV / EBITDA	Enterprise Value	$\text{Basic EBIT} + \text{Depreciation} + \text{Amortization}$

iQ^{method}™ is the set of BofA Merrill Lynch standard measures that serve to maintain global consistency under three broad headings: Business Performance, Quality of Earnings, and valuations. The key features of iQ^{method} are: A consistently structured, detailed, and transparent methodology. Guidelines to maximize the effectiveness of the comparative valuation process, and to identify some common pitfalls.

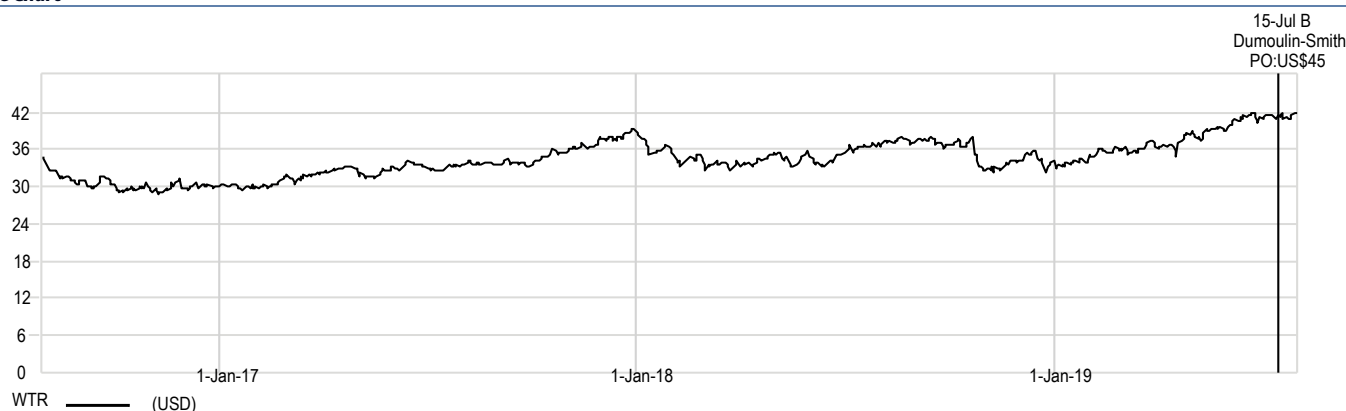
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Disclosures

Important Disclosures

WTR Price Chart



B: Buy, N: Neutral, U: Underperform, PO: Price Objective, NA: No longer valid, NR: No Rating

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark grey shading indicates the security is restricted with the opinion suspended. Medium grey shading indicates the security is under review with the opinion withdrawn. Light grey shading indicates the security is not covered. Chart is current as of July 31, 2019 or such later date as indicated.

Equity Investment Rating Distribution: Utilities Group (as of 30 Jun 2019)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	61	44.20%	Buy	47	77.05%
Hold	42	30.43%	Hold	30	71.43%
Sell	35	25.36%	Sell	27	77.14%

Equity Investment Rating Distribution: Global Group (as of 30 Jun 2019)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1516	51.23%	Buy	942	62.14%
Hold	687	23.22%	Hold	431	62.74%
Sell	756	25.55%	Sell	380	50.26%

* Issuers that were investment banking clients of BofA Merrill Lynch or one of its affiliates within the past 12 months. For purposes of this Investment Rating Distribution, the coverage universe includes only stocks. A stock rated Neutral is included as a Hold, and a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

* Ratings dispersions may vary from time to time where BofA Merrill Lynch Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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